Woman C.P.A.

Volume 36 | Issue 1 Article 1

1-1974

Reporting Needs of the Investor and the Consuming Public

Frances Stone

Reporting Needs of the Investor and the Consuming Public

Dr. Frances Stone, CFA
New York City

The author looks at financial statements from the point of view of the trained financial analyst and makes some pungent remarks about what she sees.

This article is adapted from a speech Dr. Stone gave to a meeting of the Ohio Society of CPAs.

Dr. Stone is a financial analyst in the Security Research Division of Merrill Lynch, Pierce, Fenner & Smith in New York City. She received her Ph.D. in Economics from Columbia University and teaches courses in finance at New York University and the City University of New York.

Dr. Stone is a frequent contributor to the Analysts Journal, Barron's, *and other financial journals. She chairs the Financial Accounting Policy Committee of the Financial Analysts Federation and is a member of the National Association of Business Economists. She also serves as a representative of the financial analysts on the Financial Accounting Standards Advisory Council.*

The consuming public for accounting products is the professional security analyst. The many discussions about providing understandable information for the individual investor are not in accord with reality. Only the rare individual purchaser of stocks reads — and the even more singular person understands — the joint product of accountants and corporate managers. The output should therefore be designed for the "real consumer," the professional analyst who communicates with the 31 million individual investors as well as their representatives: the institutional money managers.

Characteristics of Professional Analysts

To describe the analysts reference is usually made to the 14,000 members of the 43 local societies which combine to form the Financial Analysts Federation (FAF). Some of these societies use the title "security analyst," others use "financial analyst." Obviously there is a schizophrenic attitude among the members of the Financial Analysts Federation.

More information on the jobs of analysts is discernible from the main functions of the employers. Two-thirds of the analysts work for institutions: banks, insurance companies, investment advisors, pension funds, mutual funds. Consequently, the majority of them are employed on the "buy" side of the investment process. The remainder are employed by the brokerage community or the "sell" side. This includes the full-line broker, like Merrill Lynch; the institutional research house, like Donaldson, Lufken, & Jenrette; the regional firm, like Piper, Jaffray; and literally thousands of firms located throughout the U.S. and Canada. The European analysts are loosely affiliated with the FAF and function in a fashion similar to that of their U.S. counterparts.

The analyst in the research department of an institution is responsible for a limited number of companies. These are usually listed on an "approved selection list" or a "watch list." Analysts working for brokers are usually involved with a more diversified as well as a larger list of companies.

Chartered Financial Analysts

The professional analyst carrying the title of Chartered Financial Analyst (CFA) has, like the CPA, met certain qualifications. These include five years of experience as an analyst and passing grades on three examinations. These tests cover accounting, economics, quantitative techniques, financial analysis, evaluation of securities, as well as portfolio management and ethics.

The CFA and the FAF have a written code of ethics. A growing body of rules and regulations circumscribes the analysts' activities in their relationships with corporate management, clients, the public, and their own accounts. Among the topics which are ever more emphasized by the Securities and Exchange Commission (SEC) are standards of professional advisors and analysts' methods of handling insider information. Prospects are for the CFA program to serve as a basis for professional designation.

Accounting on the CFA Examination

Accounting is a main topic in the CFA testing program. The list of readings in this area is indicative of the knowledge required to understand and analyze for future implications the accounting methods used on financial statements.

Naturally, analysts must be able to compute a variety of ratios with items on the balance sheet, the income statement, and the statement of changes in financial position. They must also be able to understand and interpret them. In addition, the successful applicant for the CFA title must be familiar with all APB Opinions. Further expertise is essential for the complex problems of analyzing the effects of inflation on corporate results given the historical cost principle, the designation of unusual charges or gains as ordinary or extraordinary, reserves for losses, inaccuracies or irreconcilabilities in interim financial statements, reporting of affiliate results, and lease accounting for lessee or lessor. In short, the coverage parallels the topics of discussion in *The Journal of Accountancy*, a source of the readings in this area. A recent issue covered goodwill, taxes, leases, and a framework for financial reporting: everyone a prime responsibility of an analyst working to understand the reports of companies in a particular industry.

Why is the analyst's training beyond the formal schooling leading to the bachelor's or master's degree involved with accounting? The reason is obviously that the statements are used as a means of understanding and recognizing past performance. How well do the numbers indicate the past profitability of the operation? What information about future income can be derived from the historical figures? The economy and the investor gain if the statements disclose the past conditions of the company in such a fashion as to be usable for projections: the economy benefits if capital is directed into the areas of most efficient and profitable use, and the investor is helped when his or her funds are placed in the investments with the highest return.

A brief digression may be useful: The market has lately been dubbed a two-tier system. It is in actuality a three-tier market. The favorite 50 or 100 stocks, such as IBM, Avon, Xerox, Schering-Plough, Johnson & Johnson, and J.C. Penney, sell at valuations that are three to four times as high as companies like Borden, Diamond International, Firestone, and Ford, among others. Another group which includes A-T-O and Gulf & Western, sells at even lower levels of valuation. Part of the explanation for this market differentiation is the "quality" of the earnings. "Quality" is an attribute hard to define. If it is measured by the variability of income, the first group has considerably lower rates of fluctuation than the second and is less leveraged than the third. Some other significant differences include above average rates of return on invested capital, disclosure of information that is prompt and realistic, and accounting methods that tend to be clearly explained and not changed capriciously. The earnings of the most depressed companies are not only cyclical, they are also viewed with a lack of confidence by investors due to manipulated accounting methods. The analyst must be capable of judging the quality of earnings, and to do that accounting knowledge is crucial.

Investments and Accounting

Corporate managements and innumerable mergers are relatively ineffectual in cushioning the effect of recessions on operating results. Small changes in sales — either declines or slower increases — result in large effects on profit. But management does have control over the accounting methods employed to compile the statements.

Although cyclicality is a hindrance to a higher market evaluation, suspicious accounting is a more powerful deterrent. Studies have been conducted on investors' perceptions of differences in accounting methods. The results clearly show that manipulating earnings may be fun, but the long-term effects are doubtful.[1] An increase in reported income due to an accounting change has a temporary positive effect. Beyond the immediate period when the surge in profits is reported, the positive effect on the stock price erodes and becomes negative. Two reasons account for the ultimate decline in market price: 1) accounting changes can rarely be duplicated in the following years, and 2) most companies utilizing accounting changes are in poor earnings trends. The change is a temporary palliative, papering over a sick condition.

In effect, the analysis of income statements should permit the analyst to lay bare the base of permanent earning power. The historical numbers alone or even the changes in them have little or no relationship to current changes in stock prices.[2] This does not lead to the conclusion that the numbers are a costly extravagance. Why incur the cost of computing and publishing the data for the financial statements if they may be irrelevant to the investment process? The more logical question to ask is: how can these numbers be improved to serve as a basis for forecasting future profits or losses? It is the expectation of profitability and stability of this earning power that is the significant influence on stock prices. If the behavior of the stock market is considered in this context, then the absence, or the presence, of vitality at various periods becomes more understandable.

Current Analytic Thinking

In the present state of the analytic art, the influence on stock prices is recognized as being divided roughly at 31% from the direction of the market, 12% from the industry, 20% from the company, and the remainder of 37% due to all other factors including random events.[3] The analyst can reduce the risk inherent in a stock and supply meaningful input to the investment decision only to the degree that some of the uncertainties regarding the future for the industry and the company are eliminated or isolated. These two factors account for approximately one-third of the total risk. (Current theory extends the logic further and hypothesizes that a fully diversified portfolio would eliminate all except market influence.)

Corporate Accounting

Historical financial statement numbers must be usable to a degree for extrapolation by a sophisticated analyst. Have the amounts been compiled under the same accounting methods for the past five years? Can the reports be used as a basis for next year's estimate? Is there stability in the company's results?

Experience with a wealth of reports has led analysts to expect a change in accounting methods. Pension plan actuarial assumptions have been the 1972 device for supporting earnings. It has displaced a change in inventory valuation methods and depreciation methods, the overwhelming favorites for previous years. A sale of a portion of the business allows for a variety of treatment. The 1973 contribution to the body of accounting manipulations will be the reporting of foreign currency gains and losses. This will range from treatment as an extraordinary item, to inclusion in income without separate treatment, and to deferral. Two advertising companies with the same auditor are examples of the diversity in reporting profits on dollar devaluation: one shows it as ordinary income, the other as an extraordinary item.

The list of accounting abuses is long. The selection of the most favorable accounting method to enhance income has been spelled out by many. They include Abe Briloff's articles and his book *Unaccountable Accounting,* as well as many articles in the *Financial Analysts Journal.*

A list of some of the notorious practices would include the use of footnotes that are notable for the obscurity of the language, the lack of detail on effects of accounting changes (hopefully this will be cleared up by rigorous application of APB 20), the continuous change in accounting methods, the use of a variety of techniques to report the same item in the same industry, the netting of items to arrive at an "immaterial" amount, the dearth of fourth-quarter reports, the avoidance of compliance with the SEC regulation to report sectors of a diversified company to public stockholders. In summary: there are many reports that are unusable. One might suggest a simple rule for analysts: if the accounting has been changed or if it is very complicated and the notes are obscure, avoid the stock.[4]

There are, however, some positive aspects. Price-level statements are being used in conjunction with historical cost figures.[5] More experimentation with this kind of estimate as well as current values might provide analysts with accounting numbers that are relevant for investment decisions. An estimate of the effect of an alternate accounting treatment on the balance sheet and the income statement will enhance the reader's capability to decide intelligently on the value of the company (FIFO vs. LIFO for instance).[6] A complete explanation of lease agreements with the obligations for the next five years shown is the basis for an informed analysis of the financial condition of a company and its outstanding debt.[7] There are some divisions of sales that have been logically formulated as well as carried through to net income.

Conclusion

The user of financial statements has a need for information disclosed in sufficient detail to provide a basis for calculating trend, stability, financial condition. In order to accomplish this task the analyst needs numbers that are comparable from year to year and from company to company within an industry. All companies in an industry do not at present have to report on the same basis, but an explanation of the differences should be published. Changes in accounting

(Continued on page 25)

allocations must be made between periods. The statement of financial activities would not involve allocation of any kind and, except for estimating highly probable cash effects, no other estimates or interpretations of the significance of events would be included.

The Study Group also considered the relationship between private enterprise and society. It was concluded that a financial statement objective was to report enterprise activities affecting society which could be determined and described or measured.

With regard to governmental and not-for-profit organizations, the objective determined by the Study Group was that their financial statements would provide information to evaluate how well resources were being used to attain specific goals. Performance measures would have to be quantified in terms of identified goals.

Finally, the qualitative characteristics of information included in financial statements were considered by the Study Group separately from the financial statement objectives. These characteristics would be relevance and materiality (as related to the user's decision), reliability, freedom from bias, comparability, consistency, understandability, and the recognition of substance over form.

The objectives developed by the Study Group are not revolutionary. Concepts such as the use of current values rather than historical cost and the furnishing of forecasts might be considered controversial. However, the report is a starting point and implementation is the next step.

Accounting Principles Board Disbanded

The work of the APB was not totally completed at June 30, 1973 when it was disbanded and bequeathed its many problems to the Financial Accounting Standards Board. The last four opinions issued by the APB have been and will be discussed and interpreted in other professional publications. It is our purpose here to simply remind our readers of their effective dates. These are:

No. 28 Interim Financial Reporting

All interim periods relating to fiscal years beginning after December 31, 1973

Data for the comparable interim period of the prior year should be restated to conform the prior period presented with the current period, or the effect on the prior period data should be disclosed.

No. 29 Accounting for Nonmonetary Transactions

Transactions entered into after September 30, 1973, and those recorded during a fiscal year which includes October 1, 1973

Transactions recorded in a fiscal year ended prior to October 31, 1973, should not be adjusted.

No. 30 Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions

Events and transactions occurring after September 30, 1973

Retroactive restatement may be made for previously reported events and transactions occurring during the fiscal year which includes September 30, 1973.

When comparative statements are presented, prior peiod operations of discontinued segments of a business may be reclassified as explained in the opinion.

No restatement should be made for other events and transactions occurring in fiscal years ended prior to October 1, 1973. Appropriate disclosure should be made in notes to the financial statements for differently classified similar items and transactions of prior periods.

No. 31 Disclosure of Lease Commitments by Lessees

Fiscal periods ending on or after December 31, 1973

Required disclosures are to be made for all lease agreements without regard to the date any agreement was entered into.

Publicly held companies must also comply with the expanded disclosure requirements of Accounting Series Release No. 147 issued by the Securities and Exchange Commission in October 1973. These are effective for financial statements filed after November 30, 1973.

Reporting the Needs of the Investor
(Continued from page 6)

methods are not solely for the purpose of a short-term rise in income but for legitimate business objectives. Further, the differential effects of such changes should be described. This list of needs is long, and there are many problems. The Financial Accounting Standards Board has chosen topics from a list of over 30 controversial areas.

Analysts do not merely want more information, they want clear and unmuddied numbers. A little less creation and a little from analytic description from accountants would be most welcome.

Footnotes

[1]Robert S. Kaplan and Richard Roll, "Investor Evaluation of Accounting Information: Some Empirical Evidence," *The Journal of Business*, April 1972.

[2]James Lorie and Richard Brealey, *Modern Developments in Investment Management* (New York: Praeger Publishers, 1972.).

[3]Benjamin F. King, "Market and Industry Factors in Stock Price Behavior," *The Journal of Business*, January 1966, Part II, pp. 139-190; and Stephen J. Meyers, "A Re-Examination of Market and Industry Factors in Stock Price Behavior," *The Journal of Finance*, June 1973, pp. 695-705.

[4]Leasco Corp. publishes a monthly compilation called the *Disclosure Journal*. The information is selected from the SEC reports. The list of accounting citations is long.

[5]Indiana Telephone Corp. Annual Report.

[6]Caterpillar Tractor Co. Annual Report.

[7]J. C. Penney Corp. Annual Report.

APB Opinion Number 22
(Continued from page 9)

principles it particularizes only accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives
b. Specific industry principles and methods
c. Unusual or innovative applications of generally accepted accounting principles.

Conclusion

APB Opinion No. 22 with its disclosure prescriptions must be accepted for what it is — a palliative for poorly defined objectives and standards within the accounting profession. The practitioner may derive some comfort from realization that the profession has yet to mature into an art/science.

The new Financial Accounting Standards Board can, and will, contribute authoritative guidelines that will represent the best interests of the economy. The eventual effect should be a restoration of prestige to the accounting profession so that it will be relieved of the onus of explaining away its confusion.

Footnotes

[1]"The impact of SEC's new disclosure rules, *Business Week*. January 6, 1973, p 58

[2]*Objectives of Financial Statements*, (Arthur Andersen & Co.; Chicago, Ill., 1972), p 86

[3]Eldon S. Hendriksen, *Accounting Theory*, (Homewood, Illinois: Richard D. Irwin, Inc., 1970) p 561

[4]R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing*, (AAA, 1961), p 191, quoted by E. S. Hendriksen, op. cit., p 561